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IN THE

Supreme Court of the United States

OCTOBER TERM, A. D. 1941.

No. 283

BUTLER BROTHERS, A CORPORATION,
Appellant,

vs.

CHARLES J. McCOLGAN, AS FRANCHISE TAX COMMISSIONER OF THE STATE OF CALIFORNIA,
Appellee.

ON APPEAL FROM THE SUPREME COURT OF THE STATE OF CALIFORNIA.

APPELLANT'S REPLY BRIEF.

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THE GUNTHORP-WARREN PRINTING COMPANY, 310 WEST JACKSON, CHICAGO

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MAY IT PLEASE THE COURT:

Any detailed reply to Appellant's brief seems to us unnecessary. As a matter of fact Appellee's argument is in substance anticipated and answered in Appellant's original brief.

The Facts.

Appellee challenges certain statements as to factual matters which appear in Appellant's brief in the summary of the argument. See Appellee's brief, page 2.

We think the challenged statements are fairly supported by the stipulation. Paragraph 2 of the stipulation (R.

p. 8) states that stocks of goods are maintained at each of the company's houses "from which sales in the respective territories served by each house are made. Each house serves a separate trade territory, having its own sales force, and all sales made by the company in the State of California are made from the San Francisco house. * * * It is agreed that all receipts from sales made in California have been credited to the San Francisco house." There is nothing in this to suggest that the San Francisco house's trade territory is limited to the State of California, and does not embrace other states. Paragraph 8 of the stipulation (R. p. 10) states that in 1935 the total sales made by the company at all houses amounted to $66,326,000, "of which $5,206,000 were made from the San Francisco house." Paragraph 1 of the stipulation (R. p. 8) states that the company maintains and operates "wholesale distributing houses at Chicago, Illinois; Minneapolis, Minnesota; St. Louis, Missouri; Jersey City, New Jersey; Baltimore, Maryland; Dallas, Texas; and San Francisco, California.

Appellant's statements which are challenged by Appellee were prompted by the fact that in the opinion of the court below it is said that a percentage formula of allocation was approved by the California court in *Matson Navigation Co.* v. *State Board*, 3 Ca. (2d) 1, 43 Pac. (2d) 805, and inferentially approved by this Court when the *Matson* case was affirmed. *Matson Navigation Co.* v. *State Board*, 297 U. S. 441. In our original brief, at page 47, we pointed out that there was no question whatsoever in that case as to apportionment, and that the only question was as to whether the percentage formula of allocation there applied was to be applied to a base which included receipts from interstate and foreign commerce, and that this Court in its opinion in that case stated that "no question of apportionment" was there involved. (See Appellant's brief, p. 48.) At no time has it been claimed by

Appellee that so far as the San Francisco house is concerned Appellant has not accounted with respect to receipts derived from sales in interstate commerce, that is, sales involving shipments from the warehouse at San Francisco to customers in other states. And there has been no issue at any time between Appellant and Appellee with respect to any such question. As a matter of fact, we note that the *Matson* case is not even mentioned in Appellee's brief, nor is any claim made in his brief that receipts of the San Francisco house derived from sales in interstate commerce have been omitted. We would assume that Appellee will concede this to be the fact, when the case is orally argued. Under the circumstances, therefore, it would seem that Appellee's criticism is inconsequential.

Appellee also questions our statement (Appellant's Brief, p. 15) that Appellant's net income was $1,149,677 after taking into consideration the loss at San Francisco of $82,851. It is said (Appellee's Brief, p. 2) that such statement is not found in the record. Again we think the statement is fairly supported by the stipulation. Paragraph 7 of the stipulation (R. p. 10) states that in 1935 "the operations of all houses of the company produced a profit of $1,149,677" and that the state's percentage formula was applied to that figure. Paragraphs 2 to 5, both inclusive, state how the operations are carried on and how the accounts of the company are kept at its several houses. The accounts of the company in the light of the company's operations as they are actually conducted show a loss at the San Francisco house of $82,851. If the total result of all the company's operations is $1,149,677, such figure necessarily reflects the loss at San Francisco. And there is no contention, as we understand it, that Appellant's total net income exceeds $1,149,677.

But again without regard to the literal accuracy of Appellant's statements, we respectfully submit that the stipulation of facts is adequate to bring this case within

the rule of the *Rees* case and to require a reversal of the judgment of the California Supreme Court.

The Law.

Appellee, by an extremely tortuous process of argument (Appellee's Brief, pp. 7-24) which we find difficult to follow, contends that in the case of a unitary business a percentage formula method of allocation is *necessarily* valid and must *necessarily* be sustained. And on page 23 of his brief Appellee learnedly argues the case of the two horses—a situation far removed from the instant case. That Appellee's contention is as stated above conclusively appears when he concludes (Appellee's Brief, p. 24) that "the separate accounting method is wholly unsuited to the proper apportionment of the income of a unitary business," and that "it is believed that the only proper method for making the apportionment is to employ a formula which gives weight to the various factors responsible for the earning of income," etc. And see Appellee's Brief at pp. 40-43.

It is also obvious that in the light of the stipulated facts Appellee is forced to take this extreme position, viz., that without regard to the factual situation a percentage formula of allocation is valid. And we believe it is fairly to be said that the essence of Appellee's case is that the *Rees* case, applying the principle recognized in the *Underwood* and *Bass* cases, was wrongly decided and should be overruled, and that the principle itself recognized by this Court in all the cases, and repeatedly applied (See Appellant's Brief, p. 39, *et seq.*) is unsound. Appellee's contention is itself unsound, and not only is without support in the decisions of this Court, but is opposed by the very cases upon which he chiefly relies.[1] And in the *Rees* case the court

1. *Underwood Typewriter Co.* v. *Chamberlain*, 254 U. S. 113; *Bass, Ratcliff & Gretton* v. *State Tax Commission*, 266 U. S. 271; *North American Cement Corporation* v. *Graves*, 299 U. S. 517.

applied the principle which it had recognized in the *Underwood* and *Bass* cases when it said (283 U. S. at page 132):

> "Evidence which was found to be lacking in the *Underwood* and *Bass* cases is present here. These decisions are not authority for the conclusion that where a corporation manufactures in one state and sells in another the net profits of the entire transaction as a unitary enterprise may be attributed, regardless of evidence, to another state."

And further:

> "But the fact that the corporate enterprise is a unitary one in the sense that the ultimate gain is derived from the entire business does not mean that for the purpose of taxation the activities which are conducted in different jurisdictions are to be regarded as 'component parts of a single unit' so that the entire net income may be taxed in one state regardless of the extent of which it may be derived from the conduct of the enterprise in another state."

In the *Bass* case the court considered the business, in so many words, as a unitary business (266 U. S. at page 282). Nevertheless the decision turned not upon that fact but upon the fact that as in the *Underwood* case it was not shown that the

> "application of the statutory method of apportionment has produced an unreasonable result."

And likewise the decision in the *North American* case turned not upon the nature of the business as being unitary, but upon the fact that it [the formula]

> "has not been shown to have been so applied as to violate Appellant's constitutional rights"—citing in that connection the *Bass* case.

At page 26 of his brief Appellee persists in arguing that Appellant's business is a unitary business. In that connection Appellee apparently makes a distinction between the effect of the language used in paragraph 9 of the stipulation that the addition of purchases or the reduction in the volume of purchases "in an amount equal" to those made for the San Francisco house would not affect

Appellant's aggregate purchasing power, and the effect had the language omitted the words above quoted. This seems to us to be largely a quibble. As a matter of fact, the words quoted were omitted by the California appellate court in its first opinion, and Appellee's petition for rehearing sought to capitalize thereon. That court said, however, in denying the rehearing, that no point was made by Appellee arising out of the omission of the words mentioned, and that the words had appeared in the statement of facts in the opinion. And further, that Appellee was claiming that the court had failed to note that part of the stipulation, but that such facts have not been omitted and that "they may state a general law of economics but as the parties had definitely stipulated with reference to the operations of the San Francisco branch the latter facts must control as applying to this specific instance." (Underscoring by the court.)

Appellee's real objection seems to be that in some way the provisions of paragraph 9 of the stipulation should be disregarded and that in some way the controlling factor is the statement appearing in paragraph 8 of the stipulation (R. p. 10) that "by reason of the volume of purchases made by the company more favorable prices are obtained than would be obtainable with respect to purchases for the account of any individual house operated by the company."

But even so, inasmuch as it appears that the San Francisco house has been charged for the merchandise purchased for its account only the actual cost thereof based upon the company's aggregate purchasing power, we fail to see how that house has been prejudiced or how any greater benefit can be credited to it because of Appellant's aggregate purchasing power, or "purchasing differential" as it is termed by Appellee. Appellee's argument based upon the two horses indicates his view that the San Francisco house was to be charged for its merchandise purchases at something less than the actual cost thereof. It seems to us that Appellee's argument with respect to the

metal blocks (Appellee's Brief, pp. 28-29) is of the same caliber as his argument with respect to the two horses.

As to Appellee's argument commencing on page 31 under his heading "C" the same is answered in detail in our original brief. In our comments with respect to the *North American Cement* case we referred (Appellant's Brief, p. 35) to the accounts which were sought to be used before the New York State Tax Commission, and said we assumed that those accounts would be set forth in Appellee's brief in this Court. We find that the statements have been so included in the appendix to Appellee's brief commencing at page 49.

Under his heading "D" (Appellee's Brief, p. 38) it is insisted that the stipulation in the instant case comes within the condemnation of this Court as expressed in *Norfolk & Western Ry. Co.* v. *Maxwell*, 297 U. S. 682. That case was discussed at some length in our original brief commencing at page 65. Appellee states nothing in his argument with respect to that case which was not anticipated in our original brief.

Under his heading "E" Appellee renews his contention that a percentage formula of allocating income is the only possible method to be employed. The arguments advanced are those heretofore advanced in this Court, but without avail where the factual showing demonstrates that the percentage formula method of allocation works out unreasonably or arbitrarily. We are confident that this Court will hold that where the operations in the taxing jurisdiction—here California—have been conducted at an actual loss amounting to $82,851 a percentage formula of allocation is in point of law unreasonable and arbitrary when it converts such a loss into a supposed taxable gain of $93,551.50—a difference of $175,000. Consistently with the *Rees* case, the State of California may not, by applying a mere formula, create $175,000 of income out of nothing, or appropriate that much income from some other taxing

jurisdiction in order to produce revenue for itself. In either event the operation and application of the statutory allocation formula is unreasonable, arbitrary, and confiscatory. And the resulting tax is invalid within the principle of the *Rees* case.

At page 43 of his brief Appellee endeavors to sustain the action of the California Supreme Court in indulging in inferences and presumptions adverse to Appellant, and deciding the case accordingly. Without unduly stressing this aspect of the case, the effect of paragraph 12 is not, as Appellee seems to contend, to permit the court, if it deems the stipulation inadequate to establish a fact necessary to the decision, to speculate as to the fact and determine the case in the light of its own conjectures and speculation. Rather it is to require, as the stipulation in terms provides shall be done, namely, the reopening of the case for further proof.

The situation thus presented, and what the court below has done, is not merely to apply a local rule of practice (Appellee's Brief, p. 44), but it is in effect to deny Appellant an opportunity to be heard.

We respectfully urge again that the judgment of the court below cannot be sustained consistently with the *Rees* case. We further submit that the stipulated facts, without more, show the case to be one where the percentage method of allocation for tax purposes results unreasonably and arbitrarily.

We therefore ask that the judgment appealed from be reversed with instructions that judgment be entered for Appellant.

Respectfully submitted,

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